ARBOR

Small Multifamily Investment Trends Report

Q2 2022

Topics

- State of the Market
- Lending Volume
- Arbor Small Multifamily Price Index
- Cap Rates & Spreads
- Expense Ratios
- Leverage & Debt Yields
- Outlook

Cap Rates Compress as Buyers Seek Inflation Protection via Multifamily Assets

Key Findings

- Small multifamily originations are on pace to hit $91.1 billion in 2022, just shy of 2021's record high.
- Cap rates reached a new record low in the second quarter, declining to 5.0%.
- Amid surging rents and property-level incomes, expense ratios have returned to pre-pandemic levels.

State of the Market

Storm clouds continue to gather for the U.S. economy and advanced economies around the world. After the U.S. gross domestic product shrank at a 1.6% seasonally adjusted annualized rate in the first quarter of 2022 and current forecasts anticipate another contraction in the second quarter, talks of an impending recession are omnipresent.

Headlining the list of concerns impacting the U.S. economy is inflation. According to the U.S. Bureau of Labor Statistics (BLS) Consumer Price Index, prices of goods and services increased 9.1% from one year ago through June — the highest mark since 1981. As a result, the financial markets are betting that the Federal Reserve will need to keep its foot on the gas at upcoming policy meetings, raising the cost of capital via hiking its Federal Funds rate.

While the macroeconomic landscape has caused stock market investment returns to sink negative thus far in 2022, multifamily real estate has maintained its resiliency. As has historically been the case, during periods of rising interest rates, would-be homeowners tend to re-engage with the rental market as mortgage costs rise, placing upward pressure on rental housing demand.

The multifamily sector and small asset sub-sector continue to benefit from a unique set of circumstances. Residential commercial real estate continues to attract new buyer demand as investors seek assets that can quickly absorb inflationary pressures. Small multifamily prices continued to press higher at a double-digit annual rate in the second quarter of 2022 and cap rates sank to new all-time lows. According to

First American, cap rates may be poised to shift higher in the coming months, particularly if benchmark interest rates and property-level incomes keep ascending. All else equal, small multifamily remains to be a sector buttressed by a favorable balance of tenant and investor demand, a sign of stability during a period of heightened business cycle volatility.

Lending Volume

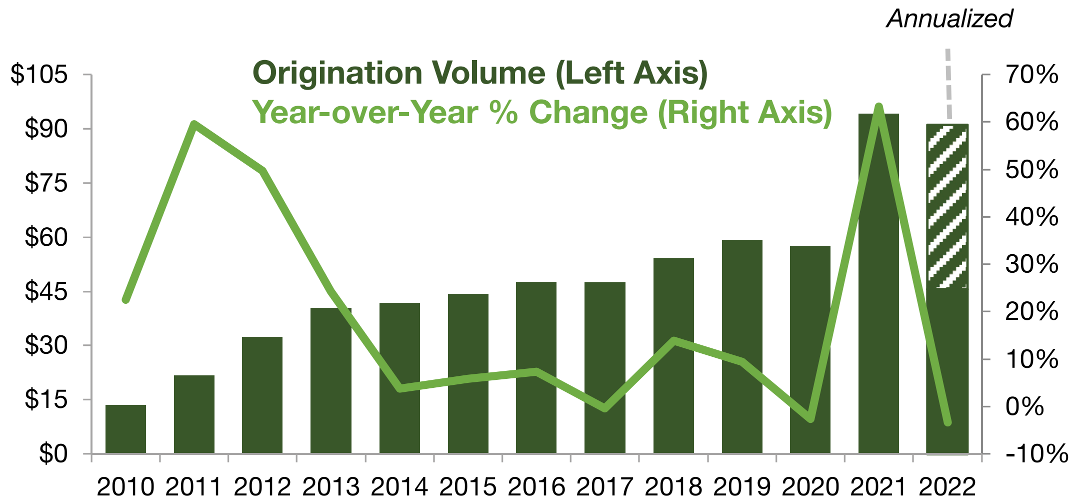
The year-end 2021 estimate of new multifamily lending volume on loans with original balances between $1 million and $7.5 million[1] — including loans for apartment building sales and refinancing — surged to $94.1 billion *(Chart 1)*. The record total represented both a wave of pent-up investment demand that sat on the sidelines during the pandemic uncertainty of 2020 and the anticipation of monetary tightening. 2021's originations total represented an annual increase of $35.6

CHART 1

Estimated Small Multifamily Origination Volume

In Billions $, Through Q2 2022

Source: Chandan Economics



[1]All data, unless otherwise stated, are based on Chandan Economics' analysis of a limited pool of loans with original balances of $1 million to $7.5 million and loan-to-value ratios above 50%.

billion (up 63.3%) from the year prior.

Through 2022's halfway mark, small multifamily originations are on pace to reach $91.1 billion. While 2022's year-to-date pace would reflect a slight 3.3% annual decline, the fact that origination totals remain in the same stratosphere as the 2021 record is noteworthy.

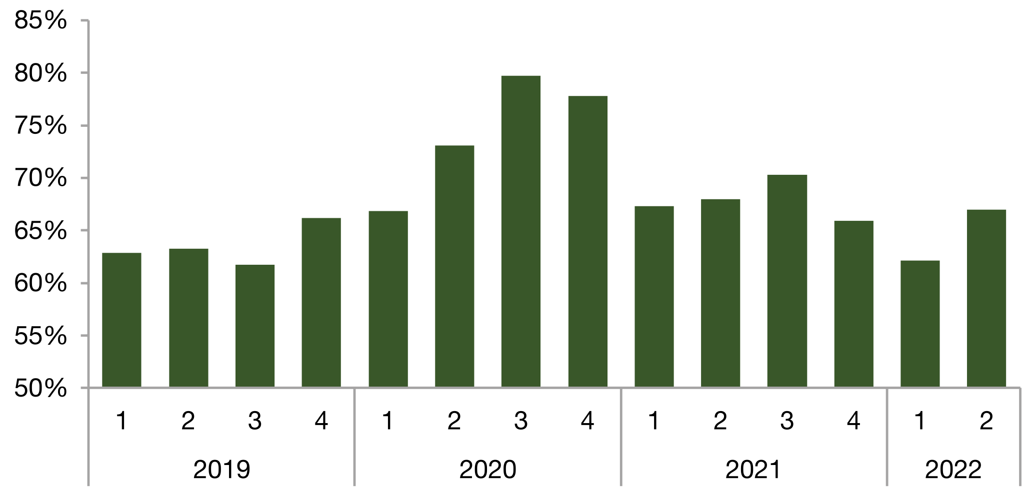
A key factor that led to an unprecedented surge in origination volume last year was a wave of refinancing activity ahead of the Federal Reserve initiating its interest rate hikes. However, even as interest rates rose off of their record lows, refinancing activity did not appreciably fall. In the second quarter of 2022, the refinancing share of small multifamily originations jumped up by 488 bps to land at 67.0% — the highest share since the third quarter of 2021 *(Chart 2)*. Beyond stability in refinancing, a growing investor appetite for multifamily properties in a high inflation environment is the other causal factor keeping originations near record levels.

CHART 2

Refinancing Share of Small Multifamily Lending

Through Q2 2022

Sources: Freddie Mac; Chandan Economics



Arbor Small Multifamily Price Index

As measured by the Arbor Small Multifamily Price Index[2], small multifamily asset valuations continued to grow at a robust rate in the second quarter of 2022, notching quarterly and annual gains of 2.6% and 12.1%, respectively *(Chart 3 and Chart 4)*. Compared to the pandemic low point (in the second quarter of 2020) asset valuations are up by 26.0%. Moreover, valuations are up by 21.6% over where they were before the start of the pandemic.

CHART 3

Arbor Small Multifamily Price Index

Q1 2000 = 100, Through Q2 2022

Sources: Arbor Realty Trust; Chandan Economics

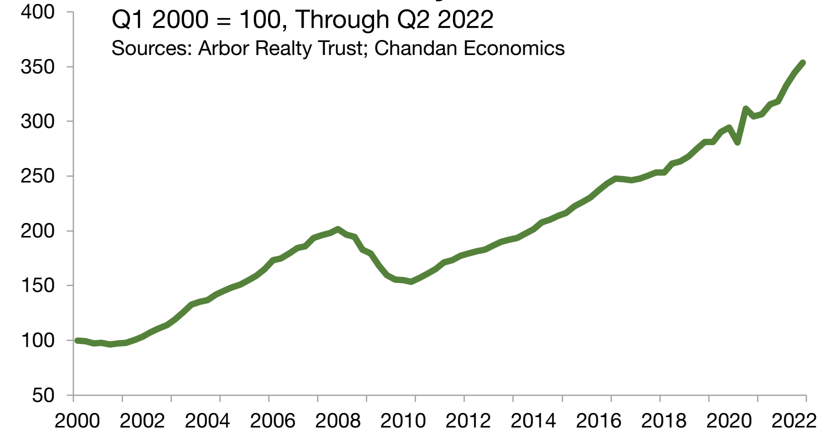
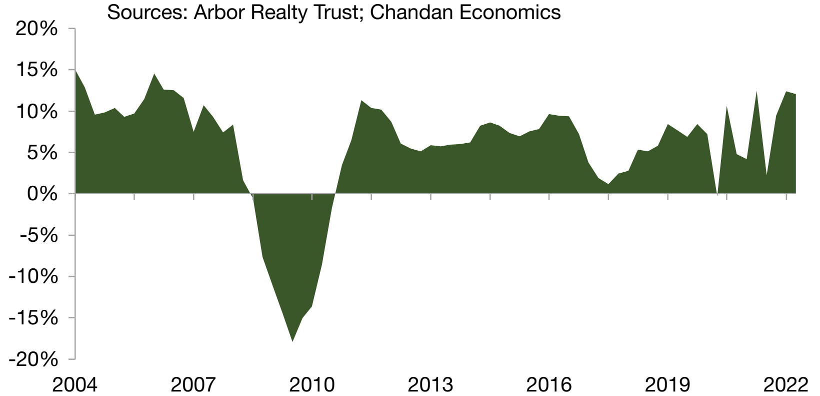


CHART 4

Arbor Small Multifamily Price Index

Year-over-Year % Change, Through Q2 2022

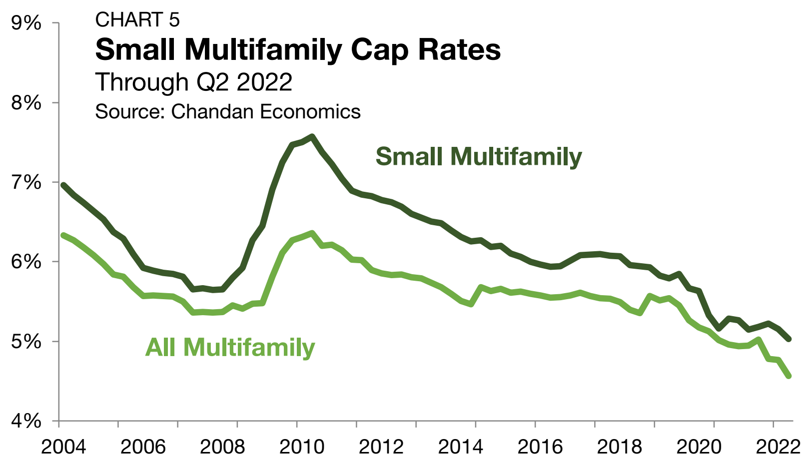
Sources: Arbor Realty Trust; Chandan Economics



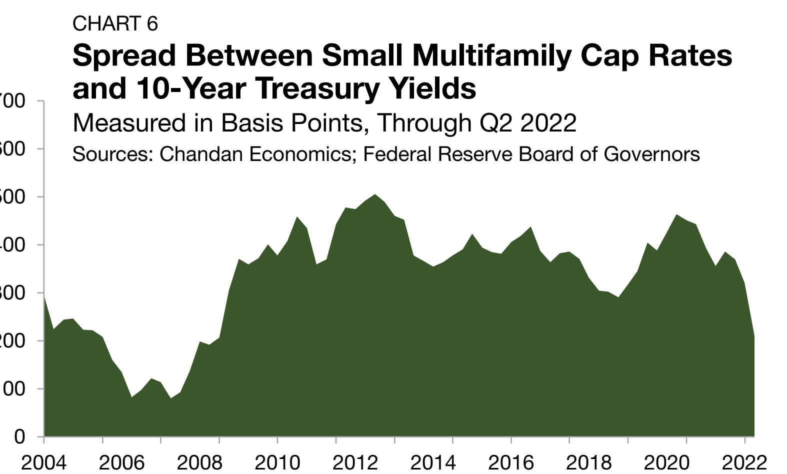
[2]The Arbor Small Multifamily Price Index (ASMPI) uses model estimates of small multifamily rents and compares them against small multifamily cap rates. The index measures the estimated average price appreciation on small multifamily properties with 5 to 50 units and primary mortgages of $1 million to $7.5 million. For the full methodology, visit arbor.com/asmpi-faq.

Cap Rates & Spreads

National average cap rates for small multifamily properties declined to a new all-time low in the second quarter of 2022, dropping 12 bps to land at 5.0% *(Chart 5)*. Small multifamily cap rates had held near 5.2% for four consecutive quarters before the second quarter's compression.



The small multifamily risk premium — a measure of additional compensation that investors require to account for higher levels of risk — is best measured by comparing cap rates to the yield on the 10-Year Treasury. The average small multifamily risk premium cratered in the second quarter of 2022, falling from 320 bps to 210 bps— its lowest level since 2008. *(Chart 6)*. The narrowing spread comes as cap rates have fallen and Treasury yields have



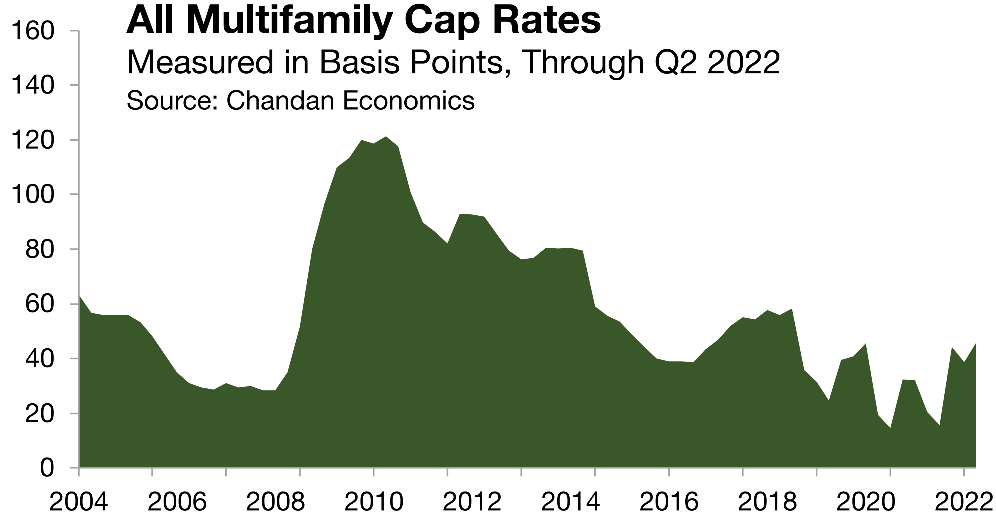
soared by nearly a full percentage point amid monetary tightening and increasing inflation. The cap rate spread between small multifamily assets and the rest of the multifamily sector — a measure of the risk unique to smaller properties — increased slightly by 7 bps during the second quarter of 2022, settling at 46 bps *(Chart 7)*.

CHART 7

Spread Between Small Multifamily and All Multifamily Cap Rates

Measured in Basis Points, Through Q2 2022

Source: Chandan Economics



Expense Ratios

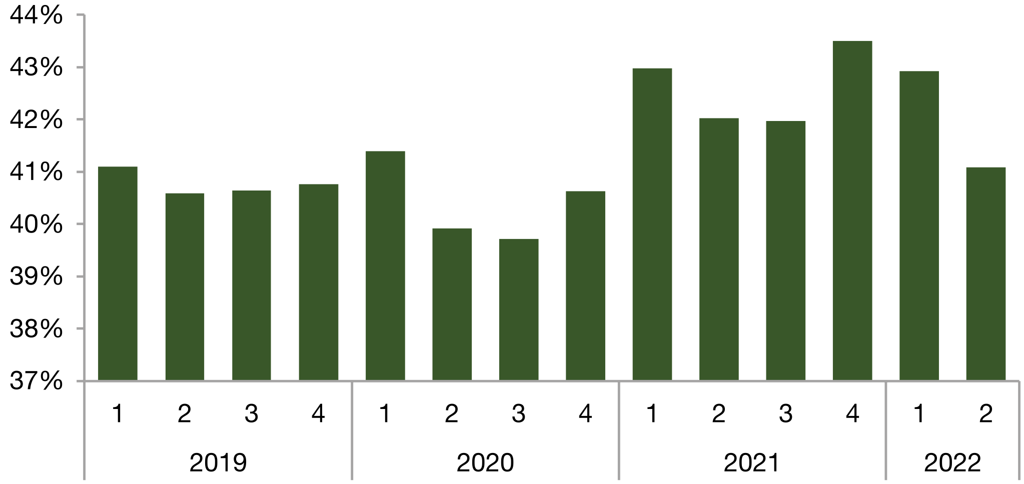
Expense ratios, measured as the relationship between underwritten property-level expenses to effective gross income, surged for small multifamily properties in 2021 — averaging 42.6% for the year, up from 40.7% and 40.4% in 2019 and 2020, respectively *(Chart 8)*. Growing expense ratios last year were likely due to several factors, including abrupt increases in operating costs and higher than average collection losses. An analysis by the National Apartment Association pegs rising insurance premiums and an increase in 'wear-and-tear' from tenants who spent more time in their homes as two of the main reasons for the increase.

CHART 8

Small Multifamily Expense Ratios

Through Q2 2022

Source: Chandan Economics



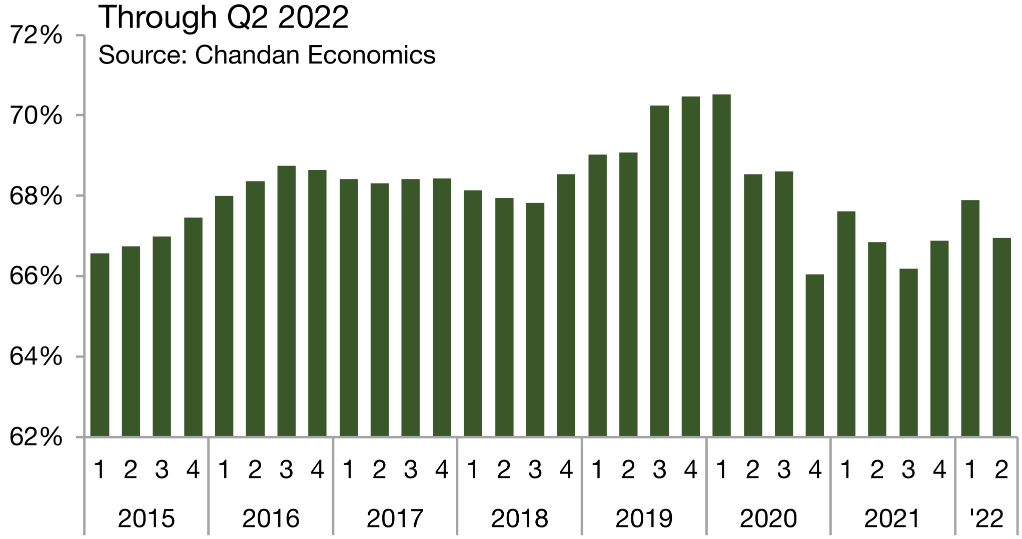
Further, according to a Chandan Economics analysis of RentRedi data, on-time rental payments were still in recovery in 2021, averaging 78.9% for the year — 228 bps lower than the 2022 average through June (81.2%).

Small multifamily expense ratios came back in line with pre-pandemic levels, declining 183 bps between the first and second quarter, landing at 41.1%. The improvement comes as rent collections have normalized and operators have had a longer period to reset rents in an extended high inflation environment. According to Freddie Mac, multifamily net operating incomes grew by nearly 20% in the 12 months ending in June 2022. Moreover, Yardi Matrix reports that multifamily rents were up an average of 13.7% year-over-year in June — exceeding the uncomfortably high 9.1% inflation rate over the same period.

Leverage & Debt Yields

During the first year of the pandemic, loan-to-value ratios (LTVs) on newly originated small multifamily loans cratered — declining from 70.5% in the first quarter of 2020 to a low of 66.0% by the end of the year. While LTVs have recovered slightly from their 2020 depths, momentum has been uneven. LTVs reached a recent high of 67.9% in the first quarter of 2022 but then proceeded to decline 94 bps in the second quarter, landing at 67.0% *(Chart 9)*. With market pricing of multifamily assets rising at a rapid pace in early 2022, the fact that LTVs failed to climb back to near pre-pandemic levels is a sign of disciplined lender underwriting in the face of growing macroeconomic uncertainty.

CHART 9
Small Multifamily LTVs
Through Q2 2022
Source: Chandan Economics



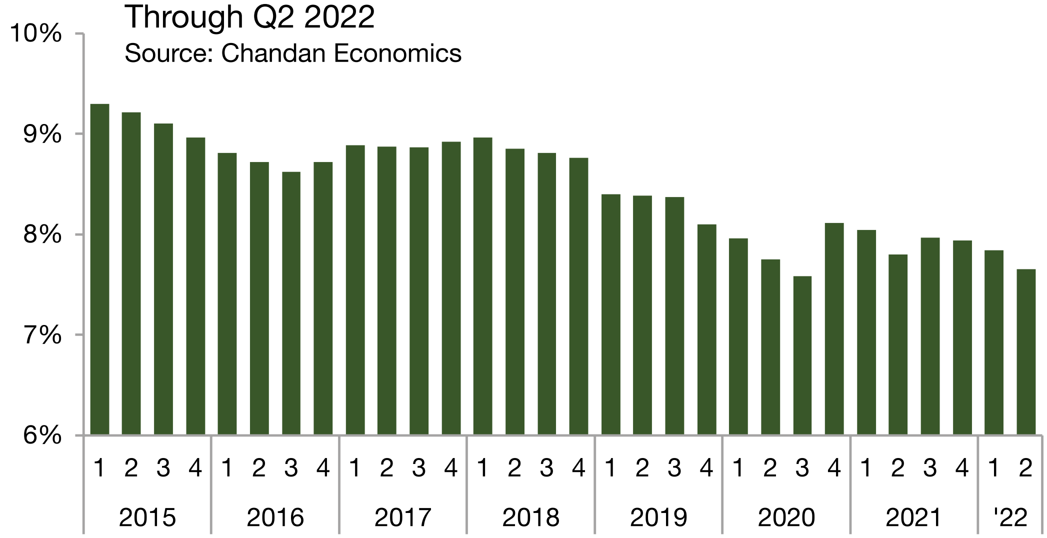
Debt yields for small multifamily loans fell by 19 bps to 7.7% in the second quarter of 2022 — just 7 bps above its all-time low *(Chart 10)*. The inverse of debt yields (the debt per dollar of NOI) rose for small multifamily loans in the second quarter. Small multifamily borrowers secured an average of $13.06 in new debt for every $1 of property NOI, up 32 cents from the previous quarter.

CHART 10

Small Multifamily Debt Yields

Through Q2 2022

Source: Chandan Economics



Outlook

The small multifamily sector maintained its stability through 2022's first half, even as the broader macroeconomic environment has become less predictable. With small multifamily risk premiums falling to their lowest levels since 2008 amid ascending Treasury rates, it is increasingly likely that there will be some upward cap rate pressure. However, even if asset price growth cools in the months ahead, underlying valuations are on a strong footing as broader housing market fundamentals should elevate rental demand over the short term. Single-family mortgage credit availability tightened in each month during the second quarter as borrowing costs rose higher — both factors should increase the number of households interested in multifamily housing. On balance, while the small multifamily sub-sector is not immune from disruption, it is favorably insulated to rise above the current set of business cycle headwinds.

arbor.com/small-loans 833.578.0312

ARBOR

ARBOR